VZCZCXYZ0010
RR RUEHWEB

DE RUEHMO #2868/01 2700628
ZNY CCCCC ZZH
R 260628Z SEP 08
FM AMEMBASSY MOSCOW
TO RUEHC/SECSTATE WASHDC 0130
INFO RUEATRS/DEPT OF TREASURY WASHDC
RHEHNSC/NSC WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC

C O N F I D E N T I A L MOSCOW 002868

SIPDIS
SENSITIVE

STATE FOR EUR/RUS, EEB/IFD
TREASURY FOR TORGERSON
DOC FOR 4231/MAC/EUR/JBROUGHER
NSC FOR WARLICK

E.O. 12958: DECL: 09/26/2018
TAGS: ECON EFIN EINV RS
SUBJECT: RUSSIAN INDUSTRIAL OUTPUT: TEETERING, NOT FALLING

REF: A. (A) MOSCOW 2122
¶B. (B) MOSCOW 2804

Classified By: Minister Counselor Eric T. Schultz for reasons 1.4 (b, d
)

¶1. (C) Summary. On the heels of the Russian stock markets' precipitous free fall, the publication of August's industrial output figures, marginally lower than analysts had predicted, contributed to calls for government intervention, mainly in the form of increasing liquidity and tax breaks. A more balanced examination, however, reveals that while Russian industrial growth may not be reaching its potential, it looks set to expand over the long term, albeit more slowly. Both supply and demand side factors are contributing to the slowdown: overall, credit and liquidity are tighter, and expansion in some sectors has slowed. Moreover, some Russian investors are moving capital out of the country to destinations such as the U.S. to benefit from tariff and market advantages abroad. In light of these factors, industry's needs and demands are being heard at the highest levels of the GOR. In the coming weeks, the GOR, caught between the Scylla of inflation and the Charybdis of anemic output, will have to make hard choices on whether or not to accommodate industrial interests with looser fiscal and tax policies. The bets are that the government, which definitively delayed consideration of a VAT cut until 2009, will continue to adhere to its policy of fiscal prudence. End Summary.

The Statistics

¶2. (U) RosStat's figures for August show a 4.7 percent increase in industrial growth, somewhat lower than the 5.0 percent analysts were predicting. Nonetheless, it was an improvement over previous months: 0.9 percent in June (which many analysts consider an outlier, caused by external factors such as the 2008 World Cup, which affected productivity) and 3.2 percent in July. Growth for the same period in 2007 was 3.7 percent. Moreover, these numbers include output in both the manufacturing and extractive sectors. These figures are "raw", whereas the ones from 2007 are "adjusted" to include output from SME production, once it becomes available.

Credit Constraints

¶3. (SBU) Growth in the manufacturing sector has been largely financed from abroad, and the subprime induced credit crunch

began affecting Russia at the end of 2007, when foreign money become virtually unavailable to Russian borrowers. With the dearth of new inflows, companies have been reduced to scrambling to refinance maturing obligations rather than expanding or modernizing. Large capital outflows in August reduced local liquidity, which has now spread into a general crisis of confidence in the banking sector. SME lending, mortgage financing, real estate, and construction will suffer most dramatically. MIRAX Group, a leading and well-connected Russian real estate conglomerate, which has been denying liquidity problems since April, has canceled $4 billion of new investment projects. Other real-estate developers are also facing trouble with their projects, ranging from malls throughout Russia to a $4 billion infrastructure project connected with the 2014 Winter Olympics in Sochi.

¶4. (C) Oleg Vyugin, the Chairman of the Board of MDM, one of Moscow's leading banks (and former director of the Federal Financial Market Services), told us that an increase in perceived Russia risk linked to TNK-BP, Mechel, and GOR actions in Georgia has exacerbated the situation. Both large and small companies feel the credit crunch, although large state corporations and those connected to government insiders are less vulnerable as they will inevitably receive government support for expansion plans. After all, he noted, their collapse would lead to a large increase in the unemployment rate. Current policies, whereby the Ministry of Finance and the Central Bank are increasing liquidity, will help improve the credit situation over the long run. In the meantime, the temporary tightening of bank credits to the manufacturing sector may have an unintended upside as it could serve to cool an economy some feared was overheating, Vyugin commented.

¶5. (SBU) Tight credit has also contributed to flattening production by reducing demand. A case in point is the electricity generating sector, which enjoyed impressive growth until 2006. The privatization of RAO UES was premised on the assumption of similar year-on-year growth based largely on anticipated domestic demand. Prospective investors in the sector not only counted on the revenues continued robust expansion would bring, but also committed to improvements, which are now turning out to be costly (due to exorbitant construction costs) and unnecessary (since there is currently no demand for the electricity the improvements will produce). Aluminum producers face similar problems as prices in the metal sector have fallen more than 20 percent and buyers have begun holding back on their purchases, seeking for even bigger bargains. The slowdown in demand could lead to the closure of some smelters, particularly high-cost, inefficient ones.

Structural Problems

¶6. (C) Tight credit is not the sole factor behind the slowdown in industrial output. Labor intensive sectors, such as construction, are also constrained by low labor supply. Russia has long relied on "migrant" labor from Central Asian republics for manual work, but Russia's generally restrictive and often corruption-riddled migration policy has not been helpful in inducing the required numbers of guest workers. Generally, Russian labor is expensive, and inflation brings with it constant pressure for wage increases. The demographic situation (a steady decline in the working age population) and the lack of managerial cadres with Western business skills compound the labor problem. A senior analyst at the Institute for the Economy in Transition, Sergei Drobishevkiy, told us that in addition to tight credit and labor constraints, the construction industry is among the sectors feeling that effects of an appreciating dollar, which increases the cost of imported construction machinery. Extraction industries are similarly affected.

More Compelling Opportunities Abroad

¶7. (SBU) For certain Russian investors, the grass is greener overseas. Some large conglomerates, such as Severstal, have bought production facilities in the U.S. or Canada to avoid import tariffs and take advantage of larger consumer markets and better infrastructure. According to analysts at Deutsche Bank, Russian investors have also been attracted by higher profit margins and access to technology, know-how, and natural resources.

GOR Policy Choices

¶8. (C) In the coming weeks, the government is expected to make some major pronouncements on tax and budget policy. Industrial "lobbyists", i.e., Union of Industrialists, metals/minerals/commodities exporters are making widely publicized noises about tax relief to stimulate production. According to Vyugin (also a former member of the Central Bank), the government will continue to follow a policy of fiscal prudence -- or conservatism. This view is shared by many of our contacts at investment banks and economic think tanks. They side with the prevailing view at the Ministry of Finance that VAT reduction will not benefit producers, but only add to inflationary pressures. Further, since VAT revenues account for one third of federal budget revenues, arguments that reductions would provide targeted support to the non-energy sectors that President Medvedev wants developed are likely to carry little weight. Indeed, consideration of VAT tax relief has been delayed until 2009, in spite of the pressure.

¶9. (C) Reduction of profit taxes (which has been successful in the past) is a better remedy for stimulating production, many argue. So far, the only relief that the GOR has offered industry is an effective reduction in oil export duties. Realization of Medvedev's so-called innovation economy is not likely to founder from a lack of federal funding. Analysts believe that the Government can find the resources for

infrastructure development. The long-term problem is that there is no coordinated strategy by the GOR to diversify the economy and develop innovation and in the current environment, Russian and foreign funds are more reluctant to invest in these new sectors.

¶10. (C) Meanwhile, the Russian Government's attempt to create conglomerates that include important sectors in need of time and expertise to reach their production potential appears to have borne little fruit. Rostechnologia, a high-tech defense-related concern (reftel A), is a case in point. It was created this summer in an ambitious bid to support both Russia's civil aviation and car manufacturing industries. August and September already saw the cessation of operations of one of its companies, AirUnion, which could not pay for jet fuel and was grounded, with no apparent assistance from its parent company. In an inexplicable move, another Rostechnologia company, AvtoVAZ, recently announced a non-existent joint venture with Caterpillar in Novosibirsk. While the purpose of the press release may never be elucidated, Rostechnologia is apparently unable or unwilling to bring clear thinking and strategic support to AvtoVAZ's future.

Comment

¶11. (C) The slowdown in output growth can be attributed in large part to the intensifying liquidity and credit crunch, as well as the outflow of capital and lack of investor confidence. This crisis may force manufacturers to introduce sorely-needed efficiency measures to reduce costs. The larger problem, however, remains the lack of a strategic vision on how to wean the economy off of its dependence on extraction industries and modernize its industrial base. The government has been debating internally for months over the

wisdom of using some of the budget surplus to invest in creating the foundations of President Medvedev's much-touted innovation economy. While this remains the government's avowed goal, the distractions of the Georgian conflict and the financial crisis have caused a delay. Whether the GOR can get the reforms back on track will be a major test of Medvedev's young presidency.
BEYRLE